



**REPUBLICANS
OVERSEAS
FOUNDATION**

ENDING THE UNJUST TAXATION OF OVERSEAS AMERICANS

SOLUTIONS FOR TAX FAIRNESS

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REPUBLICANS OVERSEAS FOUNDATION

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EXECUTIVE SUMMARY

- The United States taxes its citizens living abroad based on their worldwide income (which includes both U.S. source income and non-U.S. foreign source income), a unique practice compared to other countries.
- Americans living abroad face severe challenges from double taxation, enhanced compliance burdens, and difficulty planning for retirement.
- Moving from citizenship-based taxation to the worldwide standard of residence-based taxation would eliminate most of these issues.
- Three proposed solutions would completely sever **citizenship** from **residency** when determining how to tax income. These solutions (in preferential order) are:
 - **Legislation.** Amend the Internal Revenue Code to define 'all United States **residents**' as subject to U.S. worldwide taxation and clarify that overseas Americans would only be taxed on local source income generated within the United States. *This is the only permanent solution to completely separate citizenship from income taxation in the U.S. tax code.*
 - **Treasury regulation.** The U.S. Treasury Department could, by regulation, redefine the word 'individual' in the Internal Revenue Code to mean 'resident.' This would restrict U.S. worldwide taxation to **residents** of the U.S. The U.S. would no longer tax overseas American citizens on their non-U.S. source income.
 - **Treaty amendments.** The U.S. government includes a 'savings clause' in international treaties that allows the U.S. to tax overseas American citizens as if the treaties did not exist. This provision would be removed from the treaties so overseas American citizens would be treated as non-resident foreigners. The U.S. would no longer tax overseas American citizens on their non-U.S. source income.
- Republicans Overseas recommends **changes in legislation to the Internal Revenue Code** to sever citizenship from income taxation under the Internal Revenue Code.
- Moving to residence-based taxation would:
 - Allow overseas Americans to live and conduct financial activities (including running small businesses) like other residents in their country of residence.
 - Reduce American multinational corporations' costs to hire Americans for overseas positions.
 - Potentially provide cost savings to the U.S. Treasury.

THE BACKGROUND TO CITIZENSHIP-BASED TAXATION

The United States is unique in taxing the non-U.S. source income earned by its citizens living abroad.

This paper will refer to income as follows:

- ‘Local source income’ – income generated within a country’s borders. (*For example, ‘U.S. local source income’ means income sourced in the United States.*)
- ‘Foreign source income’ – income generated outside a country’s borders. (*For example, U.S. ‘foreign source income’ means income sourced outside the United States.*)

Nations tax their residents’ income in different ways:

- **No income taxation.** Nations such as the Cayman Islands impose no income tax on local-source income or their residents’ foreign source income.
- **Territorial taxation.** Places such as Hong Kong tax all local source income by residents and non-residents but do not tax residents’ foreign source income.
- **Residence-based taxation (‘RBT’).** Many nations follow a form of residence-based taxation. These nations tax all local source income within their borders by residents and non-residents AND tax their residents’ foreign source income. They do not tax their non-resident citizens on their foreign source income.
- **Citizenship-based taxation (‘CBT’).** Only the United States and Eritrea practice CBT. These nations tax all local source income by residents and non-residents, their residents’ foreign source income, AND their non-resident citizens’ foreign source income.

Please see Appendix 1 on page 8 for a comparison chart.

No other country besides the United States has such sweeping and draconian income taxation laws. The recent enactment of the Foreign Accounts Tax Compliance Act (‘FATCA’) has brought these U.S. citizenship taxation policies into the open and has caused extreme hardship for overseas Americans.

A comprehensive background of the laws and decisions underpinning CBT [can be found here](#).

Republicans Overseas worked closely with former Congressman George Holding (R – NC2) to draft [H.R.7358 - Tax Fairness for Americans Abroad Act of 2018](#). This bill would have improved but not resolved the income tax issues faced by overseas Americans because it did not sever citizenship from taxation. Therefore, we do not recommend it as a model for future legislation.

PROBLEMS WITH CITIZENSHIP-BASED TAXATION

The U.S. citizenship tax regime directly causes problems for U.S. citizens living in other countries. The problems include but are not limited to:

- **Double taxation of Americans living abroad.** Double taxation is sometimes partially mitigated by foreign tax credits and the Foreign Earned Income Exclusion.
- **Double taxation of small American-owned foreign businesses.** This is a particular problem for overseas Americans who operate small businesses in their country of residence. Overseas Americans who wish to run small, incorporated businesses in their country of residence are faced with U.S. tax laws, which 1) facilitate double taxation and 2) burden them with costs not shared by their local competitors.
- **U.S. taxation of specific income streams not taxed in the country of residence.** An example is the capital gains tax on the sale of a principal residence.
- **Reducing the ability of overseas Americans to engage in financial and retirement planning.** The U.S. frequently does not recognize non-U.S. pensions or tax-favored retirement planning accounts as tax-deferred, thereby diminishing retirement planning opportunities for overseas Americans.
- **Preventing overseas Americans from investing in non-U.S. financial products.** The U.S. deems most non-U.S. mutual funds as Passive Foreign Investment Corporations ('PFICs') and subjects them to punitive U.S. taxation. This can be particularly problematic because many countries do not permit the direct sale of U.S. financial products to their resident American citizens.
- **Increased costs for American corporations operating abroad.** U.S. citizen employees are associated with higher regulatory costs, which creates disincentives for hiring them. These costs put these U.S. corporations at a disadvantage to their foreign competitors if they hire U.S. citizens.
- **Denial of standard banking services to overseas Americans by non-US banks** in response to the imposition of the Foreign Account Tax Compliance Act ('FATCA').
- **Increased citizenship renunciation.** Since the enactment of FATCA and the FATCA intergovernmental agreements, citizen renunciation has skyrocketed. Many overseas Americans feel they must renounce U.S. citizenship to avoid being disabled by the U.S. income taxation system from supporting their families.

The comments and experiences of those directly impacted by U.S. citizenship taxation are expressed in the results of the Stop Extraterritorial American Taxation ('SEAT') survey, [which is available here](#).

Testimony on how U.S. citizenship-based taxation damages overseas Americans and the countries in which they live can be found in the ["SEAT Working Paper Series."](#)

POSSIBLE SOLUTIONS TO END CITIZENSHIP-BASED TAXATION

The United States should no longer apply its tax laws extraterritorially to the non-U.S. source income of U.S. citizens residing in other countries. This can be achieved in three ways:

1. **Changes in legislation** to amend the Internal Revenue Code to sever citizenship from income taxation
2. **Changes in regulations** made under and authorized by the Internal Revenue Code
3. **Changes in U.S. tax treaties** that would operate to prevent the taxation of overseas Americans rather than entrench/facilitate the taxation of overseas Americans

In all three potential solutions, the changes focus on severing “citizenship” from the definition of U.S. tax residency so that overseas U.S. citizens would no longer be subject to U.S. worldwide taxation based solely on their citizenship (circumstances of birth). Instead, they would be subject to taxation based on their residency (circumstances of life).

However, the legislative solution is the only option that would completely remove citizenship-based taxation from U.S. law. The other two options would maintain citizenship-based taxation but mitigate its harmful effects by providing mechanisms that allow overseas Americans to be treated as nonresident foreigners regarding their foreign-source income.

In all three possible solutions, U.S. citizens would continue to be taxed on “U.S. source” income as defined in Sections 861 – 865 of the Internal Revenue Code. Generally, this would mean they would be taxed on all work done in the United States, passive income received from U.S. sources, and the sale of U.S. real estate. The proposals would mean that U.S. citizens living overseas would NOT be subject to U.S. taxation on their non-U.S. source income.

SOLUTION ONE: LEGISLATION TO AMEND THE INTERNAL REVENUE CODE

A legislative solution is the only option to completely transition the U.S. to residence-based taxation. All other options leave citizenship-based taxation in place but partially mitigate its harmful effects.

Currently, the Internal Revenue Code defines ALL individuals worldwide as subject to U.S. worldwide taxation. Then, it provides a “carve out” for nonresident aliens who are subject only to taxation on U.S. source income.

The proposed amendment to the Internal Revenue Code would define ALL “residents of the United States” as being subject to U.S. worldwide taxation and provide a “carve out” for nonresidents who would be subject to taxation ONLY on U.S. source income.

Several conforming amendments would be required to effectively change the U.S. definition of tax residency from all “individuals” to all “residents.” Descriptions of these amendments [can be found here](#).

An additional explanation of the proposed legislative changes [can be found here](#).

U.S. residents would remain subject to U.S. taxation on their “worldwide income,” while nonresidents would be subject to taxation on only their U.S. source income. Notably, this means the U.S. would adopt the international standard of defining “tax residency.”

SOLUTION TWO: CHANGES IN TREASURY REGULATIONS DEFINING ‘INDIVIDUAL’ IN THE INTERNAL REVENUE CODE

This option leaves citizenship-based taxation in place but allows overseas Americans to be treated as nonresident foreigners regarding their foreign source income.

The best and most enduring solution would be to make the legislative amendments to the Internal Revenue Code as described in Solution One. Absent changes to the Internal Revenue Code, it is possible to solve the problem of “citizenship taxation” through Treasury Regulation. This solution is thoroughly described in [A Simple Regulatory Fix For Citizenship Taxation](#) by SEAT members John Richardson, Laura Snyder, and Karen Alpert.

This solution would cause the Treasury Regulations to define “individual” in the Internal Revenue Code as “resident in the United States.” In other words, the Internal Revenue Code would continue to proclaim that all “individuals” are subject to “worldwide taxation,” but “individual” would now (by regulation) be defined as “resident in the United States.”

This solution was discussed in a [Tax Notes interview](#).

SOLUTION THREE: CHANGES IN U.S. TAX TREATIES TO PREVENT TAXATION OF OVERSEAS AMERICANS

This option leaves citizenship-based taxation in place but allows overseas Americans to be treated under U.S. tax treaties as nonresident foreigners on their foreign source income.

It is a myth that U.S. tax treaties are designed to prevent the double taxation of U.S. citizens living abroad; in fact, the opposite is true. All U.S. tax treaties contain a “saving clause,” which generally allows the United States to impose tax on U.S. citizens.

The “saving clause” (in its present form) prevents U.S. citizens from using the standard “tax treaty residence tie-break provision,” which would allow them to be treated as tax residents of ONLY their country of residence.

Generally, if tax treaties allowed U.S. citizens to be treated as tax residents of ONLY their country of residence, they would be taxed as “nonresident foreigners.” In practical terms, overseas Americans would be taxed on ONLY their U.S. source income. This would alleviate many of the problems experienced by overseas Americans.

To understand the problem of the “saving clause” in U.S. tax treaties, [click here](#).

BENEFITS OF CHANGE

Severing citizenship from tax residency (residence-based taxation) is intended to provide the following benefits to overseas Americans and American businesses:

- **No more double taxation of overseas Americans.** Overseas Americans would continue to pay taxes to the U.S. on U.S. source income but would only pay taxes on their foreign source income to their country of residence.
- **No additional U.S. taxation of revenue streams not taxed by the country of residence.** Overseas Americans would no longer have extra taxation placed on everyday financial transactions that their neighbors do not have to pay.
- **No more double taxation of small foreign American-owned businesses.** American energy and competitiveness would be unleashed without the burden of extra and punitive taxation being levied on their businesses.
- **Overseas Americans could fully engage in financial and retirement planning.** Americans abroad would regain control over their financial future.
- **Americans could safely invest in non-U.S. financial products without being penalized by the Internal Revenue Code.** Overseas Americans would no longer be denied the benefits of investing in local, tax-advantaged retirement programs or investing in the local stock market. Country of residence-mandated pension programs would no longer be punitively taxed by the U.S.
- **Reduced costs for American corporations operating abroad.** American multinationals would no longer have to absorb the estimated 40% higher costs of hiring overseas Americans.
- **Decreased citizenship renunciations.** Overseas Americans would no longer have to choose between making a living and being an American citizen.

Additional benefits to the U.S. Treasury could include:

- **Cost reductions associated with fewer IRS personnel needed to administer the U.S. extraterritorial tax system to overseas Americans.**
- **The Foreign Earned Income Exclusion would no longer be relevant, eliminating a U.S. expenditure.**
- **[FDAP income](#) would be subject to 30% withholding** unless otherwise determined by tax treaties between the U.S. and the country of residence.

RECOMMENDATIONS

The time has come for the United States to adopt the international standard of taxing people based on **residence** (the circumstances of their life) and not on **citizenship** (the circumstances of their birth).

Republicans Overseas supports the full repeal of U.S. taxation based only on citizenship. The only permanent option to end citizenship-based taxation is to amend the Internal Revenue Code through legislation (Solution One) and sever citizenship from taxation.

U.S. citizens living overseas find that their every financial transaction is treated by the Internal Revenue Code as ‘foreign’ even though these transactions are performed in the country they call home. Overseas Americans earn a living and receive pensions; receive welfare benefits; need to acquire assets, save, invest, and plan for retirement; and need to engage in financial just like every other citizen in their country of residence. Overseas Americans have the impossible task of planning their tax and financial affairs while subject to the tax systems of two countries — the one where they live and the United States.

In addition to the punitive taxation and regulatory regimes imposed by the U.S. on overseas Americans, compliance with U.S. income tax law often makes it impossible for American expatriates to benefit from the tax planning vehicles offered in their country of residence. In essence, being subject to worldwide taxation by two tax systems often means that Americans living overseas cannot enjoy the benefits of either system but are instead subjected to the worst of both.

It is time to end the United States’ historical, burdensome system of taxing people for who they are instead of where they live.

